

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 99-0055
STATE GROSS RETAIL AND USE TAXES
For Years 1994, 1995, 1996, and 1997**

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ISSUES

- I. Sales / Use Tax - Bad Debt Deduction:** Methods used in determining taxpayer's sales and use tax liability.

Authority: 45 IAC 2.2-6-12(a); 45 IAC 2.2-6-12(b).

Taxpayer protests the auditor's method of calculating the bad debt adjustment because the auditor included in the calculation sales made to large volume customers.

- II. State Gross Retail Tax – Equipment Used in Retail Stores:** Equipment used in preparation of consumer paint products.

Authority: IC 6-2.5-2-1; IC 6.2.5-5-3(b); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(g); 45 IAC 2.2-5-12(a); Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. Tax 1983).

Taxpayer protests the assessment of sales tax on items of certain equipment purchased for use in its retail stores.

- III. State Gross Retail Tax – Quality Control Equipment Used at Powder Coatings Plant:**

Authority: IC 6-2.5-5-3; 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(d); Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 524; 45 IAC 2.2-5-8(c)(2)(G); 45 IAC 2.2-5-8(i)(2).

Taxpayer protests the assessment of sales tax on equipment and quality control equipment used at its powder coatings plant.

IV. State Gross Retail Tax – Dust Collection Installation at Powder Coatings Plant:

Authority: IC 6-2.5-1-3; IC 6-2.5-3; IC 6-2.5.5-30; 45 IAC 2.2-5-70; 326 IAC 6-3.

Taxpayer protests the assessment of sales taxes on a dust collection system used in its powder coatings plant.

V. State Gross Retail Tax – Safety Equipment and Supplies Used at Powder Coatings Plant:

Authority: IC 6-2.2-5-3(b); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(c)(2); 45 IAC 2.2-5-8(c)(2)(F); Dept. of Revenue v. United States Steel Corp., 425 N.E.2d 659 (Ind. Ct. App.1981).

Taxpayer protests the imposition of sales tax on protective glasses, safety gloves, overalls and earplugs taxpayer purchased for use by its plant workers.

VI. State Gross Retail Tax – Wrapping Materials and Shipping Pallets Used at Warehouse:

Authority: IC 6-2.5-5-9; IC 6-2.5-5-9(d); 45 IAC 2.2-5-16(a); 45 IAC 2.2-5-16(d)(3).

Taxpayer protests the imposition of sales tax on shrink-wrap, pallets, tape, packaging adhesive, and drums purchased for use at its warehouse and distribution center.

VII. Abatement of Penalty:

Authority: IC 6-8.1-10-2(a); IC 6-8.1-10-2.1(d); IC 6-8.1-10-4; 45 IAC 15-11-2; 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer requests that the imposed 10% negligence penalty be abated.

STATEMENT OF FACTS

Taxpayer is an Ohio corporation headquartered in Ohio and authorized to do business in the state of Indiana. Taxpayer is a manufacturer, wholesaler, and retailer of paint, coatings (including powder coatings), and related products. Taxpayer operates approximately 30 primary manufacturing facilities located throughout the United States including a powder coatings manufacturing facility located in Indiana. During tax years 1994 and 1995, taxpayer operated a warehouse in Indiana, in which paint and paint related products were stored for shipment to locations within and outside of Indiana.

I. Sales / Use Tax - Bad Debt Deduction:

DISCUSSION

Taxpayer protests the auditor's calculation of bad debt relevant to determining taxpayer's sales and use tax liability. Under 45 IAC 2.2-6-12(a), in determining the taxpayer's sales and use tax liability, a retail merchant shall deduct from his gross retail income from retail transactions made during a particular reporting period, the retail merchant's bad debts or uncollectible receivables. In addition, 45 IAC 2.2-6-12(b) provides that "[in] order to qualify for this exemption the retail merchant must have: (1) previously reported the transaction and remitted the sales or use tax to the Department; (2) Not collected the tax from the customer and (3) Written the receivable off for federal income tax purposes."

Taxpayer argues that the audit incorrectly determined the amount of its bad debt by including within its calculation those sales made to large volume retailers not administered through taxpayer's own retail outlets (hereinafter "wholesale"). Taxpayer maintains that these wholesale sales are made with customers who typically impose little or no risk of non-payment. Further, taxpayer maintains that because the bad debt adjustment only relates to retail store activity, wholesale sales must be subtracted from total sales.

Taxpayer maintains that an examination of the records of its individual retail outlets, on a store-by-store basis, would provide a more accurate account of its uncollectible receivables. To that end, taxpayer has supplied information ("The Taxpayer 1998 Bad-Debts Write-Off Calculation File March 2000") detailing its own method and figures for calculating net taxable write-offs for each of its individual retail stores for the year 1998.

To the extent that taxpayer is able to similarly substantiate net taxable write-offs for bad debt amounts at its individual retail stores for the years included in the audit, and to substantiate the net taxable write-offs for bad debt amounts for wholesale sales made to its large volume retailer customers, taxpayer is entitled to provide those figures to audit for consideration during the supplemental audit.

FINDING

Taxpayer's protest is sustained.

II. State Gross Retail Tax – Equipment Used in Retail Stores

DISCUSSION

Pursuant to IC 6-2.5-2-1, a sales tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Under IC 6-2.5-5-3(b), 45 IAC 2.2-5-12(a), an exemption from the state gross retail tax is provided for transactions involving manufacturing machinery, tools, and equipment if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. 45 IAC 2.2-5-8(c) defines “direct use” as use having an immediate effect on the article being produced. Property has such an immediate effect if it is an essential and integral part of an integrated process that produces tangible personal property. 45 IAC 2.2-5-8(g).

Taxpayer asserts that four items of equipment, installed at its retail outlets, come within the ambit of IC 6-2.5-5-3(b) and, therefore, the purchase of that equipment should be exempt from sales tax. The four items of equipment include: 1) Color Matching Systems, 2) Automatic Colorant Dispensers, 3) Shakers, and 4) Related Computer Equipment consisting of a CPU, monitor, keyboard, and printer.

Taxpayer produces a white base paint at its primary production facilities. This white base paint is then shipped to taxpayer’s various retail outlets. Not all the white base is identical because different colors require the use of different bases having different chemical qualities. The “gallon” containers of white base actually contain less than a full 64 ounces in order to permit the eventual addition of colorants.

Retail customers may choose paint in one of two ways. The customer may select a paint color from one of the color cards provided by taxpayer. Alternatively, customer may bring in a color sample to be custom matched. Once the customer selects or provides the desired color, taxpayer’s employee begins a process by which the specified paint is produced. If the customer has brought in a color sample, that sample is measured by the Color Matching System (a spectrophotometer or other color-sensing device). The resulting measurements are converted to a numerical value which is sent to the computer equipment. The computer equipment in turn produces a unique color formula which is sent to the Automatic Colorant Dispenser.

If the customer chooses a standard color from a color card, taxpayer’s employee enters a color identification number into the computer which is transferred to the Automatic Colorant Dispenser.

The Automatic Colorant Dispenser meters out the appropriate amount of individual colorant’s required to produce the customer’s finished paint product. The attached printer is used to produce a label, listing the color identification number and colorant ingredients, which is attached to each container of finished product.

Once colorant has been added to each paint container, the containers are placed into the Shaker and paint is properly mixed. If this last step is not completed, customers would not obtain a useable product because the colorants would not be evenly dispersed throughout the can of paint. It is not possible for customers to mix their own paint by

taking the paint home and stirring it themselves because customers would not be able to satisfactorily disperse the colorant.

Taxpayer's Automatic Colorant Dispensers are equipment used in the direct production of tangible personal property and, therefore, qualify for the gross retail tax exemption provided under IC 6-2.5-5-3(b). The functions performed by this equipment are an essential and integral part of a manufacturing process that produces tangible personal property as required by Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 525 (Ind. Tax 1983), and 45 IAC 2.2-5-8(g).

The dedicated Computer Equipment also qualifies for the exemption provided under IC 6-2.5-5-3(b). The computer links together and controls The Color Matching system and Automatic Colorant Dispenser thereby making it possible to produce a finished marketable product. As such, the Computer Equipment, in translating the coded instructions, selecting the necessary colorants, determining the amount of colorant, and controlling the dispensing of the colorants, acts as an integral part of taxpayer's manufacturing process.

Taxpayer's Color Matching systems do not qualify for the exemption afforded under IC 6-2.5-5-3(b) because the Color Matching systems operate outside of and are independent to the manufacturing process that produces the taxpayer's finished product. The Color Matching systems do not produce an immediate change on the finished product. Instead, the Color Matching systems are used to analyze the customer's paint sample and to produce data that is entered into or sent to the computerized control unit where the actual production of the finished product begins.

To the extent that taxpayer's Shakers are used to mix customized paint products, the Shakers are exempt from the gross retail tax under IC 6-2.5-5-3(b). However, to the extent the Shakers are used to mix the taxpayer's non-customized paints, the Shakers are not entitled to the exemption. In addition, to the extent that the Shakers are used to re-mix paints previously sold but which may have over time become separated, the Shakers are also not entitled to the exemption.

FINDING

Taxpayer's protest is sustained in part and denied in part.

III. State Gross Retail Tax – Quality Control Equipment Used at Powder Coatings Plant.

DISCUSSION

Taxpayer protests the assessment of state gross retail tax on gram scales, floor scales, water chiller, and quality control laboratory equipment. The quality control laboratory equipment includes a spray gun, convection oven, air compressor, vacuum pump, and

“Q-panels” (onto which paint samples are sprayed). Taxpayer argues this equipment should be exempt from the state gross retail tax under IC 6-2.5-5-3 because the equipment was acquired for the direct use in the direct production of its powder coatings product.

The courts and the Department interpret IC 6-2.5-5-3 to mean that equipment is directly used in direct production if the equipment is both integral and essential to taxpayer’s production process. 45 IAC 2.2-5-8(c). Further, if the equipment is both integral and essential to the manufacturing process it has an immediate effect on the article being produced. *Id.* 45 IAC 2.2-5-8(d) specifically excludes equipment used in pre-production and post-production activity.

Taxpayer maintains that its purchase of floor scales is exempt because it was a purchase of manufacturing equipment coming within the IC 6-2.5-5-3(b) double direct exemption. The audit disagreed determining that the purchase of the floor scales was not exempt because the scales were pre-production assets functioning outside of the taxpayer’s production process. The tax court in Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. Tax 1983) defined the production process broadly stating that the exemption “statute circumscribes all of the operations or processes by which the finished product is derived.” *Id.* at 524. This broad definition encompasses the taxpayer’s floor scales because the floor scales are a part of the integrated process of producing powder coatings where, in its initial stages, the scales are used to weigh, measure, and combine the powder coatings’ constituent ingredients. The example of exempt equipment cited at 45 IAC 2.2-5-8(c)(2)(G) is analogous to taxpayer’s floor scales. 45 IAC 2.2-5-8(c)(2)(G) states that the purchase of an automated scale process employed to measure quantities of raw aluminum used in the next production step is exempt. The fact that taxpayer’s own floor scales are not similarly automated is irrelevant because it is the relationship of the equipment at issue to the integrated production process which determines its exempt status not the particular manner in which that equipment functions.

Taxpayer’s purchase of a water chiller is exempt from tax. The water chiller has both a direct effect on and is directly used in the direct production of taxpayer’s powder coatings. Furthermore, the water chiller is exclusively dedicated for that purpose and is not used for any ancillary, non-production purposes. During taxpayer’s powder coatings production process, raw materials are mixed, heated, and transformed into a liquid state in a piece of equipment called an extruder. After leaving the extruder, the liquid material is chilled to return it to a solid form. Finally, that cooled and solidified mixture is crushed and ground into the finished powder coatings. Taxpayer’s water chiller operates at the intermediate production stage to cool and circulate the water used to transform the liquid material back into solid form.

Taxpayer’s quality control equipment is used in two situations. The equipment is used to analyze and test samples of paint produced during the actual manufacturing process, and it is used to analyze and match a particular customer’s individual paint specifications.

Under 45 IAC 2.2-5-8(i)(2), machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt. The Department interprets this regulation to exempt equipment used to test the in-process manufacturing of products which will later be sold. Therefore, to the extent that taxpayer's equipment is used to test samples, removed from the in-process production line, for qualities such as thickness, gloss, and adhesion, that equipment is exempt.

However, to the extent that taxpayer's quality control equipment is used to analyze and match customer's paint specifications, the equipment is not exempt. The equipment, used as such, constitutes pre-production assets which are outside the exemption provided under IC 6-2.5-5-3. The equipment is not directly used in the direct production of taxpayer's powder coatings. It is neither integral nor essential to taxpayer's production process.

FINDING

Taxpayer's protest is denied in part and sustained in part. Taxpayer's purchase of floor scales is exempt from tax. Taxpayer's purchase of a water chiller is exempt from tax. Taxpayer's quality control equipment is exempt from tax to the extent that the equipment is used to test samples removed during the in-process production of powder coatings. However, taxpayer's quality control equipment is taxable, as a pre-production asset, to the extent the equipment is used to analyze and match customers' individual paint specifications.

IV. State Gross Retail Tax – Dust Collection Installation at Powder Coatings Plant.

DISCUSSION

Taxpayer protests the assessment of gross retail tax on the dust collection system installed at its powder coatings plant. Taxpayer argues that the dust collection system should be exempt, under IC 6-2.5-5-3, IC 6-2.5-5-30, and 45 IAC 2.2-5-70, because the system was installed to comply with environmental standards.

The dust collection system is attached to the sifter at the end of each of the six powder coatings production lines. Residual dust is collected and transported to a container outside the building where it is later collected for landfill disposal.

IC 6-2.5-5-3 provides that sales of tangible personal property are exempt from the state retail tax if: (1) the property constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure predominantly used and acquired for the purpose of complying with any state, local, or federal environmental quality statutes, regulations, or standards; and (2) the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining or agriculture.

Taxpayer must meet the two requirements found in IC 6-2.5-5-30 before the dust collection system can be considered exempt personal property. It is clear that taxpayer meets the second of those two requirements. Taxpayer is a corporate “person,” under IC 6-2.5-1-3, engaged in the business of manufacturing paint and paint related products.

However, the auditor disagreed with taxpayer’s contention that the dust collection system was purchased for the purpose of complying with environmental quality statutes stating that, “[n]o documentation [had] been provided to support the installation of the dust collection to comply with environmental quality regulations.”

Documentation supplied by taxpayer supports taxpayer’s contention that the dust collection system was installed in order to comply with applicable environmental regulations. Document labeled “Appendix A: Emission Calculations” prepared by the Indiana Department of Environmental Management (IDEM), contains statistics related to the amount of particulate matter produced at taxpayer’s powder coatings plant. The document specifies the amount of potential particulate matter produced at taxpayer’s plant before control device (dust collector) installation, specifies the amount of particulate matter following installation of the dust collector, compares those two amounts to the amount of “allowable” particulate matter, and concludes, “this process is in compliance with 326 IAC 6-3.”

A letter from IDEM, dated December 11, 1996, notified taxpayer that, pursuant to 326 IAC 6-3, the dust collection system “*shall* be in operation at all times when the powder coating manufacturing process is in operation and *shall* not exceed the allowable particulate matter (PM) emission rate of 4.10 pounds per hour.” (Emphasis added). That same document mandates that any malfunction of taxpayer’s emission control equipment shall be reported to the Office of Air Management within four hours after the malfunction occurs.

Taxpayer is in compliance with both requirements of IC 6-2.5-5-30. Taxpayer’s dust collection system was installed “for the purpose of complying with . . . state, local, or federal environmental quality statutes, regulations, or standards.”

FINDING

Taxpayer’s protest is sustained.

V. State Gross Retail Tax – Safety Equipment and Supplies Used at Powder Coatings Plant

DISCUSSION

Taxpayer protests the auditor’s determination that its purchases of safety glasses, safety gloves, overalls, and earplugs are subject to gross retail tax. Taxpayer maintains that, under 45 IAC 2.2-5-8(c)(2)(F), this equipment is properly exempt.

Under IC 6-2.5-5-3(b) transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing or other tangible personal property. Equipment purchased for direct use in direct production must have an immediate effect on the article being produced. 45 IAC 2.2-5-8(c). Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process that produces tangible personal property 45 IAC 2.2-5-8(c); Indiana Dept. of Revenue v. United States Steel Corp., 425 N.E.2d 659, 664 (Ind. Ct. App. 1981). The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product is not determinative. 45 IAC 2.2-5-8(c)(2). Under 45 IAC 2.2-5-8(c)(2)(F), “Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production,” is exempt from tax.

Taxpayer argues that because production of its powder coatings requires very high purity levels, these items must be worn by the workers to prevent contamination of the powder coatings. Contamination would result in added expenses in producing the powder coatings and taxpayer’s customers would not receive properly manufactured goods. Taxpayer states that earplugs are essential for its workers to produce the powder coatings because, without the earplugs, workers could not perform their duties as the noise from the machinery would drastically affect their hearing.

Purchases of earplugs worn by taxpayer’s employees to prevent hearing damage in high noise manufacturing areas are exempt from tax. Purchases of overalls, to the extent that the overalls are worn exclusively within the manufacturing area, are exempt. Purchases of safety gloves and safety glasses, acquired for the purpose of protecting taxpayer’s employees from injury at its manufacturing line, are exempt from tax.

FINDING

Taxpayer’s protest is sustained.

VI. State Gross Retail Tax – Wrapping Materials, Drums, and Shipping Pallets Used at Warehouse.

DISCUSSION

Taxpayer protests the auditor’s determination that taxpayer’s purchases of shrink-wrap, pallets, tape, packaging adhesive, used in its warehouse facility are subject to the state gross retail tax. Taxpayer further asserts the auditor incorrectly assessed the tax on drums that were shipped from its warehouse facility and later returned to the warehouse for refilling. Taxpayer cites 45 IAC 2.2-5-16(c)(1) to support its position.

45 IAC 2.2-5-16(a) states that the state gross retail tax shall not apply to sales of (1) nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and (2) returnable containers containing contents sold in a sale constituting selling at retail and (3) returnable containers sold empty for refilling. IC 6-2.5-5-9 is the applicable statutory exemption.

Taxpayer's purchases are exempt from state gross retail tax to the extent that the non-returnable wrapping materials (i.e. shrink-wrap, tape, packaging adhesive) are used in sales of tangible personal property to taxpayer's retail customers. Taxpayer's purchase of those materials is not exempt from the state gross retail tax to the extent that those materials are used by taxpayer to make inter-division transfers such as transfers to its own retail stores.

Taxpayer protests the assessment of the state gross retail tax on its purchase of shipping pallets. The taxpayer maintains that, to the extent it uses the shipping pallets to make product deliveries to its customers, the initial purchase of the shipping pallets should be exempt from sales and use tax.

The applicable statutory exemption is IC 6-2.5-5-9(d) which provides that the "[s]ales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds." Therefore, the applicability of the exemption is dependent upon the contents of the container. To the extent that taxpayer is purchasing nonreturnable shipping pallets for the purpose of delivering to its customers a product for sale, the purchase of the pallets is exempt.

The taxpayer protests the assessment of the gross retail tax on its purchase of returnable drums. These returnable containers were used by the taxpayer to ship paint and paint related products and then returned to its warehouse facility for refilling. The applicable interpretative regulation is found at 45 IAC 2.2-5-16(d)(3) which clearly states in relevant part that "[t]he sale of returnable containers to the original or first user thereof is taxable." Therefore, taxpayer, as the first purchaser of its returnable containers, is responsible for paying the state gross retail tax on its initial purchase of returnable containers.

FINDING

Taxpayer's protest is denied in part and sustained in part. Taxpayer's purchases of shrink-wrap, tape, and packaging adhesive are exempt to the extent provided under 45 IAC 2.2-5-16(a), (c)(1). Taxpayer's purchase of non-returnable pallets is exempt to the extent provided under IC 6-2.5-5-9(d). Taxpayer's purchases of returnable drums are not exempt.

VII. Abatement of Penalty:

DISCUSSION

Taxpayer requests that the 10% negligence penalty, imposed under the authority of IC 6-8.1-10-2(a), be abated.

IC 6-8.1-10-2.1(d) states that if a person subject to the negligence penalty imposed under IC 6-8.1-10-2(a) can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. 45 IAC 15-11-2 defines negligence as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard of inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations.

In order to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. 45 IAC 15-11-2. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed" 45 IAC 15-11-2(c). In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits. Id.

Taxpayer argues that the 10% negligence penalty should be abated for the following reasons; 1) taxpayer demonstrated reasonable cause for the penalty to be abated, 2) taxpayer has made it a practice to file its Indiana sales and use tax returns on a timely basis, 3) taxpayer remitted substantially all (95.75%) of sales and use taxes in a timely manner, 4) taxpayer exercised reasonable care and prudence in reporting and remitting sales and use taxes.

Taxpayer has raised reasonable arguments in support of the choices it made in calculating its gross retail and use taxes. On at least one issue, the taxability of manufacturing equipment used at its retail outlets, taxpayer relied on a determination made in its favor during a previous audit, conducted in 1991, covering the years 1987-1990. Further, outside the issues raised concerning taxpayer's powder coatings plant, there is no evidence taxpayer acted in other than good faith.

FINDING

Taxpayer's protest is sustained.